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Legal Background Briefings are prepared and updated periodically by the Legal Services Division of the Iowa Legislative Services Agency, a nonpartisan agency providing legislative drafting and research services to the committees and members of the Iowa General Assembly. The Briefings provide background information regarding a particular area of law. Although a briefing may identify issues for consideration by the General Assembly, nothing contained in a briefing should be interpreted as advocating a particular course of action. The reader is cautioned against using information contained in a briefing to draw conclusions as to the legality of a particular behavior or set of circumstances.

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Legal Background Briefing on…

Lending the Credit of the State

Credit of State Not to Be Loaned

Article VII of the Constitution of the State of Iowa relates to the state's ability to contract debt. Section 1 of Article VII prohibits lending the credit of the state. Article VII, section 1, reads:

"The credit of the state shall not, in any manner, be given or loaned to, or in aid of, any individual, association, or corporation; and the state shall never assume, or become responsible for, the debts or liabilities of any individual, association, or corporation, unless incurred in time of war for the benefit of the state."

The most detailed and instructive judicial discussion of Article VII, section 1, occurs in the case of *Grout v. Kendall*, 192 N.W. 529 (Iowa 1923). This legal background briefing will initially discuss Article VII, section 1, as explained by the Iowa Supreme Court in *Grout*, and then explore issues relating to whether the state stands in any type of suretyship position and whether an obligation is mandatory or merely a moral obligation. Finally, this briefing will end with a description of the "special fund theory" adopted in Massachusetts with regard to pledges of the state's credit. Iowa has not adopted this theory with respect to lending the state's credit but has adopted the theory with respect to limitations on state debts.

Restraint on Suretyship

When the Constitution of the State of Iowa was written, Iowa, like many other states at the time, created a constitutional provision prohibiting the lending of the credit of the state. The provision was intended to prevent the financial troubles experienced by many states early in statehood when chaotic conditions prevailed and private sector

entities offered expensive, seductive promises for the public good, such as railways, canals, and water powers. When a state found such opportunities too good to resist, the state would freely offer the credit of the state and take on large amounts of secondary indebtedness, often described as the state assuming the secondary indebtedness as a surety. The financial burden of the secondary indebtedness would often mount and subject the state to significant potential financial liability.[1]

This set of circumstances, when a state assumes a secondary liability under the optimistic belief and reliance that the primary debtor will not default and, as a result, the secondary debtor will never be called upon to satisfy the debt, came to be known as the "delusion of suretyship." In the case of the states early in statehood, a state would typically undertake significant amounts of secondary indebtedness that never would have been undertaken as primary debt. As the Supreme Court stated in *Grout*, "The ultimate cry of the surety is: I would not have become surety if I had known or believed that I should have to pay the debt." Article VII, section 1, is designed to protect the state from such secondary or indirect liability and the delusion of suretyship, and, as described in *Grout*, to act as a restraint against extravagance and ill-advised undertakings.[2]

Suretyship Issues

In examining situations possibly involving Article VII, section 1, the first issue to consider is whether the state is in any type of a suretyship position. If the state is not in the position of a surety, then the situation is likely not an Article VII, section 1, violation. On the other hand, if a suretyship position does exist, then the financial relationship could be viewed by a court as unconstitutional.

In simple terms, a suretyship position exists when a secondary rather than a primary liability arises with respect to a debt or legal obligation. In other words, when one person agrees to pay the debt incurred by a second person if the second person fails to meet the second person's obligations, the first person acts as a surety and a suretyship position exists.[3] All of the cases decided by the Iowa Supreme Court regarding Article VII, section 1, make determinations of whether a suretyship situation exists.[4] All of the cases found that a suretyship situation was not present and that the Constitution was not violated.[5]

In one case, the Iowa Supreme Court considered a federal highway program that caused a relocation of utility facilities.[6] Under a state statute and upon a determination of necessity by the state, the state would reimburse a utility for the cost of relocation work provided that federal assistance to the state equaled 90 percent of the reimbursement payment. The Court found that the statute did not propose to guarantee or pay any prior indebtedness. The Court found that, until a determination of necessity was made and actual relocation occurred, there was no indebtedness. The Court found that the indebtedness was a primary indebtedness created by the state statute and not a secondary indebtedness subject to Article VII, section 1.[7]

In another case, the Iowa Supreme Court examined the issuance of bonds by the Iowa Housing Finance Authority.[8] The authority loaned bond proceeds to mortgage lenders and the mortgage lenders used the funds to provide mortgage loans for housing purposes at lower-than-market interest rates to persons who qualified as low or moderate income families. The statute required the authority to annually certify to the Governor any sum required to restore each bond reserve fund to the fund's reserve requirements. The Governor was allowed, but not required, to submit to the General Assembly a budget that included such sum. The statute provided that any sum appropriated by the General Assembly and paid to the authority was to be deposited by the authority in the applicable bond reserve fund. It was argued to the Court that the statute pledged the credit of the state by creating a moral obligation. The Court found that the statute was constitutional because no mandatory obligation was created in the statutory language since

neither the Governor nor the General Assembly was required to act.[9]

Constitutional Safeguards

A couple of possible constitutional safeguards for situations that may involve suretyship type financial arrangements have been suggested by the courts.

The first possible safeguard is suggested in *John R. Grubb, Inc. v. Iowa Housing Finance Authority*, 255 N.W.2d 89 (Iowa 1977). In *Grubb*, the Court suggests that a moral obligation is not equivalent to a pledge of the state's credit; rather, the Court suggests that mandatory language creating a legal obligation is required.[10]

The second possible safeguard has not been specifically recognized by the courts in Iowa in terms of Article VII, section 1. Massachusetts, which has a similar constitutional provision, has suggested that when a special fund is obligated for defaults, instead of a state's general fund, then an unconstitutional pledge of the state's credit does not exist.[11] While the Iowa courts have not explicitly approved the rationale of Massachusetts in Article VII, section 1, situations, the Iowa Supreme Court has adopted a similar theory, commonly known as the special fund theory, for constitutional questions involving state debts. The Court has found that revenue bonds do not constitute a state or municipal debt in violation of the debt limitations of the Constitution since the general fund of the state is not obligated.[12]

ENDNOTES

[1] Grout v. Kendall, 192 N.W. 529, 531 (Iowa 1923).
[2] Id.
[3] Id.
[4] Stanfield v. Polk County, 492 N.W.2d 648 (Iowa 1992); Train Unlimited Corp. v. Iowa Railway Finance Authority, 362 N.W.2d 489 (Iowa 1985); John R. Grubb, Inc. v. Iowa Housing Finance Authority, 255 N.W.2d 89 (Iowa 1977); Richards v. City of Muscatine, 237 N.W.2d 48 (Iowa 1975); Sampson v. City of Cedar Falls, 231 N.W.2d 609 (Iowa 1975); Stanley v. Southwestern Community College, 184 N.W.2d 29 (Iowa 1971); Graham v. Worthington, 146 N.W.2d 626 (Iowa 1966); Green v. City of Mt. Pleasant, 131 N.W.2d 5 (Iowa 1964); Edge v. Brice, 113 N.W.2d 755 (Iowa 1962); Faber v. Loveless, 88 N.W. 2d 112 (Iowa 1958); State ex rel. Fletcher v. Executive Council, 223 N.W. 737 (Iowa 1929); McLeland v. Marshall County, 201 N.W. 401 (Iowa 1924); Grout v. Kendall, 192 N.W. 529 (Iowa 1923); Merchant's Union Barb-Wire Co. v. Brown, 20 N.W.434 (Iowa 1884).
[5] Id.
[6] Edge v. Brice, 113 N.W.2d 755 (Iowa 1962).
[7] Id. at 758.
[8] John R. Grubb, Inc. v. Iowa Housing Finance Authority, 255 N.W.2d 89 (Iowa 1977).
[9] Id. at 98.
[10] Id.
[11] Opinion of the Justices to the House of Representatives, 335 N.E.2d 362, 366-7 (Mass. 1975).
[12] Farrell v. State Board of Regents, 179 N.W.2d 533, 542-545 (Iowa 1970).

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